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Supreme Court of the United States

October Term, 1946.

No. 42.

VANSTON BONDHOLDERS PROTECTIVE COMMITTEE, - - - - - - - - - - Petitioner,

versus

LOUIS A. GREEN and ROBERT HEILBRUNN, Known in these Proceedings as the GREEN COMMITTEE, and MORRIS GREEN, - Respondents.

No. 43.

VANSTON BONDHOLDERS PROTECTIVE COMMITTEE, - - - - - - - - - - Petitioner,

versus

CARL B. EARLY, DANIEL MATTHEWS, THOMAS MATTHEWS, Et. Al., - - - - - Respondents.

No. 44.

VANHORN BONDHOLDERS PROTECTIVE COMMITTEE, - - - - - - - - - - Petitioner,

versus

LOUIS A. GREEN and ROBERT HEILBRUNN, Known in these Proceedings as the GREEN COMMITTEE, and MORRIS GREEN, Et. Al., - Respondents.

No. 45.

VANHORN BONDHOLDERS PROTECTIVE COMMITTEE, - - - - - - - - - - Petitioner,

versus

CARL B. EARLY, DANIEL MATTHEWS, THOMAS MATTHEWS, Et. Al., - - - - - Respondents.

BRIEF FOR RESPONDENTS, CARL B. EARLY, ET AL.

CHAS. I. DAWSON,
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WOODWARD, DAWSON, HOBSON & FULTON,
Of Counsel.

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BRIEF FOR RESPONDENTS, CARL B. EARLY, ET AL.

OPINIONS BELOW

The opinion of the Circuit Court of Appeals (R. 214) is reported 151 F. (2d) 470. The District Court rendered no opinion, but, during argument, stated the grounds for its decision (R. 56) and, thereafter, made an order and judgment embodying findings of fact and conclusions of law (R. 192).

JURISDICTION

The judgments sought to be reviewed were entered October 9, 1945 (R. 213-214), and a timely petition for rehearing (R. 235) was denied November 26, 1945 (R. 241). The petition for certiorari of Vanston Bondholders Protective Committee was filed February 14, 1946, and the petition for certiorari of Van Horn Bondholders Protective Committee was filed February 15, 1946. In each petition for certiorari the jurisdiction of this Court was invoked under §240 of the Judicial Code, as amended, and the petition for certiorari of the Vanston Bondholders Protective Committee also invoked the jurisdiction of this Court under §24(c) of the Bankruptcy Act, as amended. Each of said petitions for writs of certiorari was granted by this Court on March 25, 1946 (R. 241-243).

STATEMENT OF THE CASE

On February 1, 1928, the debtor, Inland Gas Corporation, a Delaware corporation, executed and delivered in the State of New York a deed of trust to Chatham Phenix National Bank & Trust Company and James F. McNamara, Trustees, under which a first lien on all the property of the Inland Gas Corporation therein described, and which consisted of substantially all of its property, was given as security for the payment of an issue of $4,400,000.00 par value of 6½% first mortgage bonds maturing on the first day of February, 1938. The interest on the bonds was represented by coupons attached, payable semi-annually.

The bonds provided that they were payable (R. 197):

> "at the principal office of the Chatham Phenix National Bank and Trust Company, or its successor in trust under the Indenture hereinafter mentioned (hereinafter called the Trustee), in the Borough of Manhattan, City and State of New York, or, at the option of the bearer or such registered owner, at the principal office of the Continental National Bank and Trust Company, in the City of Chicago, State of Illinois."

The coupons provided that they were payable (R. 202):

> "at the principal office of Chatham Phenix National Bank and Trust Company, in the Borough of Manhattan, City and State of New York, or at the option of the bearer, at the principal office

of the Continental National Bank and Trust Company in the City of Chicago, State of Illinois."

The trust indenture securing the bonds and coupons provided for the payment of interest on defaulted bonds and coupons, from their respective due dates until paid, at the same rate as that applicable to the bonds before maturity (R. 204) but there is no such provision in either the bonds or coupons attached thereto.

At the time of the institution of bankruptcy proceedings substantially all of the bonds were past due and unpaid, as is true of the interest coupons which matured after August 1, 1930. The past due coupons have not been detached from the bonds or negotiated to third parties. The record contains no proof that the holders of any of the past-due bonds or coupons exercised their option to require payment thereof in Chicago, Illinois, or that the option was so exercised in respect of any of the bonds or coupons that were actually paid.

Inland Gas Corporation also has outstanding and past due since February 1, 1938, $1,450,000.00 par value of 7% debentures and $400,000.00 par value of 6% second mortgage notes (R. 100). No interest has been paid on the debentures since August 1, 1930, and no interest has been paid on the mortgage notes since January 2, 1930. *The debentures and the second mortgage notes are secured by a second mortgage on the same property embraced in the deed of trust securing the first mortgage bond issue.*

The District Court, on petition by a First Mortgage Bondholders Committee for a distribution upon first

mortgage bonds, ruled that the validity of the provision in the trust indenture for the payment of interest on defaulted interest coupons attached to the first mortgage bonds was controlled by the law of the State of New York, and that under the law of that state the provision was valid. He accordingly ruled that the holders of the bonds and attached coupons were entitled to the payment of the face of the bonds and of the attached coupons and, in addition thereto, to simple interest on the bonds and to simple interest on the past-due coupons from the date of their respective maturities until paid at 6½% per annum. The result of this ruling was to deny the second mortgage holders any substantial recovery whatever on their securities.

On appeal to the Circuit Court of Appeals for the Sixth Circuit, the ruling of the lower court was reversed, the Circuit Court of Appeals holding, as did the District Court, that the validity of the contract to pay interest on past-due coupons must be determined by the law of New York. That Court, however, held that, under the law of New York, the contract to pay interest on the defaulted coupons was against the public policy of that state and void.

QUESTIONS PRESENTED

The contentions advanced in their respective briefs by the petitioners and by the Securities and Exchange Commission are so numerous and involved that they tend to confuse, rather than to clarify, the questions upon which certiorari was sought and granted.

As we understand the case, it presents two questions:

(1) To what jurisdiction was the Bankruptcy Court required to look for the applicable law in determining the validity of the contract here involved?

(2) What is the law of that jurisdiction on the subject?

It is thoroughly settled that under the present bankruptcy law, the validity of the contract here involved is governed by local law. *Benedict, Receiver,* v. *Ratner,* 268 U. S. 353; *Security Mortgage Company* v. *Powers,* 278 U. S. 149. Indeed, the petitioners' briefs impliedly, and the brief of the Commission expressly, admit this to be true. The District Court and the Court of Appeals each held that the law of New York was controlling, but they disagreed as to the effect of that law, the District Court holding that the contract was valid under New York law, and the Circuit Court of Appeals that it was invalid.

The petitioners and the Commission contend: (1) that the law of New York is not controlling; and (2) if it is, the Circuit Court of Appeals was in error in its holding that under that law an agreement to pay interest on past due coupons is against public policy and void. We shall discuss these contentions in the order stated.

ARGUMENT

I. THE LAW OF NEW YORK IS CONTROLLING

Each of the coupons provided that it was payable (R. 202):

> "at the principal office of Chatham Phenix National Bank and Trust Company, in the Borough of Manhattan, City and State of New York, or *at the option of the bearer,* at the principal office of the Continental National Bank and Trust Company in the City of Chicago, State of Illinois." (Emphasis ours.)

It seems clear from the foregoing quoted language of the coupons that the stipulated place for the performance of the contract (payment) was the State of New York, unless and until the option to require payment in Chicago, Illinois, had been exercised. In the bankruptcy proceeding, the holders of the coupons asserted their claim to interest thereon. The allowance of interest was resisted on the ground that the contract providing for the payment thereof was made and to be performed in New York, and under the law of that state was against public policy and void. It would seem that in such situation, if a coupon holder desired to claim that the place of payment of his coupon was Chicago, Illinois, the burden was upon him to show that he had exercised his option to have payment made there. The record contains no such showing in behalf of any coupon holder. Therefore, we insist that for the purpose of testing the validity of the contract here

involved, New York must be regarded as the state in which the contract was executed and to be performed. *Braniff Investment Company, et al.* v. *Norton, et ux.*, 80 F. (2d) 598 (5th Circuit), *certiorari* denied 298 U. S. 663, is directly in point. A citizen of Texas had executed and delivered in that state his promissory note to Braniff Investment Company, an Oklahoma corporation having an office and place of business in Texas. The note provided for its payment "at the office of Braniff Investment Company, Oklahoma City, Oklahoma (or at such place as may be designated by the holder for the time being of this note)." No holder of the note ever exercised the option to require its payment at any place other than in Oklahoma City. Under these facts, the Court, writing through Judge Hutcheson, held that the note fixed Oklahoma City as the definite place of payment and

> "that the clause in parenthesis merely extended to holders the option to change it. Since there was no attempt to exercise the option, we need not consider what the effect would have been had such an attempt been made. As the note stood at the time of its making, and at the time of the trial, the place of payment fixed in it was Oklahoma City."

The petitioners urge (Vanston brief, page 16) that inasmuch as the debtor has been in either federal receivership or in bankruptcy continuously since the maturity of the coupons involved in this litigation, and those coupons still remain uncollected, the holders' option to demand payment in Illinois remains un-

impaired. However, as pointed out by Judge Hutcheson in the *Braniff Investment Company* case, *supra*, the place of payment must be determined as the situation stood at the time of the trial in which the question arose. Furthermore, the record shows, and the petitioners admit (Vanston brief, page 16), that the coupons which matured prior to the receivership proceedings were paid, yet, the record contains no showing that the holders of any coupons exercised their option to require payment in Illinois or that any of them were paid in that state.

It is familiar law that one claiming rights under an option must prove substantial compliance with its terms; and as there is no proof in the record that any holder exercised his option to have payment made in Illinois, we think it should be conclusively presumed that the option has not been so exercised as to any of the coupons. The contract here involved is entirely different from one which fixes *no* place of payment, but leaves that matter to the future determination of either or both of the parties. Of course, in such situation, as argued by the petitioners (Vanston brief, page 16), there is no place of performance until it has been designated by the party authorized so to do. The fallacy of the petitioners' argument on this point is that it proceeds from the false premise that under the contract here involved no place of payment is fixed until the coupon holder exercises his option. The contract here involved definitely fixes the place of payment. The optional provision does no more than give the holder of the securities the right to change the

place of payment. Of course, until he so changed the place of payment, it continued in New York. Certainly, the contract contemplated that bondholders and coupon holders desiring to exercise their option to change the stipulated place of payment should do so in advance of or on maturity dates. Admittedly this was not done up to the time this case was tried and decided. Hence, the contract must be viewed as one made and to be performed in New York. Therefore, it is immaterial whether the Bankruptcy Court applied the choice of law rule prevailing in Kentucky or the Federal choice of law rule, because the rule is the same in each of the two jurisdictions in such a situation. It is universally held that where a contract is made and to be performed in the same state, the law of that state is controlling as to its validity in the absence of an express stipulation to the contrary. Kentucky is thoroughly committed to that rule. *Moody* v. *Barker*, 188 Ky. 401, 222 S. W. 89; *Fry Bros.* v. *Theobald*, 205 Ky. 146, 265 S. W. 498; *Cooper's Adm'r* v. *Lebus' Adm'rs*, 262 Ky. 245, 90 S. W. (2d) 33. We know of no Federal decision to the contrary and counsel have cited none.

Even if it should be conceded that Illinois was an alternative place of performance, the concession does not help the case of petitioners. Certainly, the contract cannot be construed as fixing Illinois as the exclusive place of performance. Viewing the contract in the light most favorable to petitioners, the most that can be said of it is that it provides for its performance in part in New York and in part in Illinois, according

as the holders might, or might not exercise their optional right to designate Illinois as the place of performance. In such a situation, the Illinois court would determine the validity of the contract under the law of New York, the place where the contract was made. *Oakes* v. *Chicago Fire Brick Co.*, 388 Ill. 373, 58 N. E. (2d) 460, seems directly in point. In that case, the Court held that the validity of a contract made in another state, which provides in part for its performance in Illinois and in part in other states, must be determined not by the law of Illinois but by the law of the state where made. That case unequivocally announces the rule that under Illinois law the validity of a contract made in another state will not be determined under the law of Illinois unless the contract provides, or it is made to appear, that the parties intended that it was to be *wholly* performed in Illinois. After stating that the court had decided in the case of *George* v. *Haas*, 311 Ill. 382; 143 N. E. 54, 55, that the validity of a contract made in another state but to be performed in Illinois must be determined by the Illinois law, the court said:

> "To bring the rule anounced in George v. Haas, 311 Ill. 382, 385, 143 N. E. 54, into operation, it was incumbent upon appellant to show that the agreement was to be performed wholly within this State. Where a contract is to be performed in various States, as in this case, the *lex loci contractus* must control. Otherwise, if the place of performance is to govern, the law would find itself in a hopeless tangle."

This case also answers the intimation of adversary counsel in their briefs to the effect that the place of performance of the contract here involved is yet to be determined. Of course, such contention is wholly unjustified, as we have heretofore shown, but assuming it to be sound, the Illinois case just cited is fatal to the contention that the contract's validity must be determined by Illinois law, for in that case, and immediately following the language quoted above, the court said:

> "Where there is nothing in the contract or in the proof to show ~~whether~~ the contract is to be performed, it is governed by the law of the place where made."

If we have correctly understood the briefs of the petitioners and of the Commission, it is their contention that, even if it be conceded, as contended by us, that the contract was made and to be performed in New York, it does not follow that the law of that state is controlling as to its validity. They argue that it must be presumed that the parties did not intend to make a void contract, and if the contract would be valid under the laws of any state having a normal and vital relation to the contract (claimed by them to be Illinois, Kentucky and Delaware), or in any state in which the contract could have been put in suit but for bankruptcy (claimed by them to be Kentucky and Delaware), it should be presumed that the parties intended the law of that state to be controlling if such presumption is necessary to save the validity of the contract.

Respectable authority may be found for the proposition that parties to a contract may *by express stipulation* provide that the law of some state other than that where the contract was made or to be performed shall control, provided the state agreed upon has a normal and vital relation to the contract. Where the state agreed upon, however, is neither that of the contract's execution nor of its performance, it must appear that it has an actual and substantial relation to some important element of the contract. Thus, the court refused to enforce a stipulation in a contract that all the rights thereunder should be governed as to validity, interpretation, construction and effect, by the law of the state in which one of the parties was incorporated, that state being neither the state of the contract's execution nor of its performance, for the reason that it had no normal or vital relation to the transaction. *Brierley* v. *Commercial Credit Co.*, 43 F. (2d) 730 (3d Cir.), *certiorari* denied 282 U. S. 897; *Gerli & Co.* v. *Cunard SS Co.*, 48 F. (2d) 115 (2d Cir.); *Owens* v. *Hagenbeck-Wallace Shows Co.* (R. I.), 192 Atl. 158, 464, 112 A. L. R. 113. As the contract under consideration contained no such express stipulation as to the governing state law, the rule just adverted to has no application here.

The authorities, including Kentucky, also are to the effect that where a contract is made in one state and to be performed in another, and is valid under the law of one, but invalid under the law of the other, and there is no express stipulation as to which law shall control, it will be presumed that they contracted with

reference to the law of the state which recognizes the validity of the contract, and the contract will be enforced provided enforcement would not be against the public policy of the state of the forum.

However, we know of no case, state or Federal, holding that the court should presume, in the absence of an express agreement, that the parties intended to contract in respect of the law of a state which was neither the state of the making nor of the performance of the contract, even though such state has a normal and substantial relation to the transaction. The petitioners (Vanston brief, page 13) and the Commission (brief, page), cite *Seeman* v. *Philadelphia Warehouse Company,* 274 U. S. 403; *Cromwell* v. *County of Sac,* 96 U. S. 51; *Smith* v. *Western & Southern Life Ins. Co.,* 87 F. (2d) 830 (C. C. A. 5th); *Joffe* v. *Bonn,* 14 F. (2d) 50 (C. C. A. 3d); *Brierley* v. *Commercial Credit Co.,* 43 F. (2d) 724 (E. D. Pa.), aff'd 43 F. (2d) 730 (C. C. A. 3d), cert. denied, 202 U. S. 897; *Braniff Investment Co.* v. *Morton,* 80 F. (2d) 598 (C. C. A. 5th), cert. denied 298 U. S. 663, *supra; Merchants' & Manufacturers' Securities Co* v. *Johnson,* 69 F. (2d) 940 (C. C. A. 8th), cert. denied 293 U. S. 569; *In re: Champion Shoe Machinery Co.,* 17 F. Supp. 985 (E. D. Mo.). None of those case announces any such rule. In each of them, including the case of *Seeman* v. *Philadelphia Warehouse Company, supra,* the court was dealing only with the choice of law as between the state of the making and the state of the performance of the contract. Therefore, none of those

cases can be accepted as authority for the sweeping *assumed intent rule* contended for by our adversaries.

Petitioners assert (Vanston brief, page 20) that the rule contended for is recognized and followed in New York, and cite *Westchester Mortgage Co.* v. *Grand Rapids & Ionia Railroad Co.*, 246 N. Y. 194; *Curtis* v. *Leavitt*, 15 N. Y. 9, 227; and *Chapman* v. *Robertson*, 6 Paige 627. It is stated that the Circuit Court of Appeals in determining the law of New York entirely overlooked those cases and the principle announced by them. However, those cases no more support the contention of petitioners than do *Seeman* v. *Philadelphia Warehouse Company, supra,* and the other cases relied upon by the petitioners and the Commission. As in the *Seeman* case, *supra,* and the other cases just referred to, the court was dealing only with the choice of law as between the state of the making and the state of the performance of the contract.

II. UNDER THE NEW YORK DECISIONS, THE CONTRACT HERE INVOLVED WAS AGAINST THE PUBLIC POLICY OF THAT STATE AND VOID

Apparently, the petitioners and the Commission concede that under the New York decisions an agreement made contemporaneously with the creation of a debt to pay technical compound interest on unpaid interest installments after their maturity date is against the public policy of New York and void, but that a contract made contemporaneously with the creation of a debt to pay simple interest on such overdue interest in-

stallments is valid and enforceable under the law of New York. Unfortunately for them, they have not, and cannot, cite a single New York case in support of their contention. As we shall presently show, the New York courts, almost from the beginning of statehood down to their most recent utterance on the subject, have condemned agreements made contemporaneously with the creation of a debt to pay interest on interest installments after their maturity date, as against the public policy of the state and void, and this without regard to whether the agreement contemplated the payment of compound interest in the technical sense, or simple interest. The briefs of the petitioners and of the Commission contain no independent analysis or discussion of any of the New York cases. They are content to rely upon the analysis of those cases made by District Judge Patterson (now Secretary of War) in *American Brake Shoe & Foundry Co.* v. *Interborough Rapid Transit Company,* 26 F. Supp. 954. Inasmuch as Judge Patterson's opinion in that case contains a somewhat extended analysis and discussion of many of the New York cases upon which we rely and which we shall presently discuss, and inasmuch as we shall attempt in our discussion of those cases to show that Judge Patterson's conclusions and criticisms are not justified by the cases themselves, we believe it will be for the convenience of the Court and will avoid repetition to first consider the Patterson opinion.

Judge Patterson had before him the validity of a covenant in a deed of trust executed to secure an issue

of first mortgage coupon notes to the effect that the notes, and also any overdue coupons, should draw interest at 7% per annum after maturity. Judge Julian W. Mack, Circuit Judge, sitting as a District Judge in the same case, had considered the validity and effect of the same covenant in respect of the same mortgage coupon notes prior to Judge Patterson's decision. The question was considered and decided by Judge Mack in 1935 prior to the decision of *Erie Railroad Company* v. *Tompkins*, 304 U. S. 64. A receiver had been appointed for the Interborough Rapid Transit Company of New York and the trustee under the deed of trust executed to secure the notes and coupons had intervened and asked the instruction of the court as to whether under the covenant above referred to interest should be paid on overdue coupons after their maturity date. Judge Mack in his opinion (11 Fed. Supp. 418) said:

> "But, under New York law, the indenture provision for interest after maturity on the other two classes of interest coupons is unenforceable, as violative of the public policy of that state. Williamsburgh Savings Bank v. Town of Solon, 136 N. Y. 465, 32 N. E. 1058 (1893); Bailey v. County of Buchanan, 115 N. Y. 297, 22 N. E. 155, 6 L. R. A. 562 (1889); Young v. Hill, 67 N. Y. 162, 23 Am. Rep. 99 (1876). The question therefore as to them is whether New York law is applicable.
>
> "Despite my personal views that state law ought to control contractual obligations made and payable in the state, especially in a case in the federal court dependent for jurisdiction on di-

versity of citizenship, the law is well established since Swift v. Tyson, 16 Pet. 1, 10 L. Ed. 865 (1842), especially as to commercial paper, that a federal court in the absence of a controlling state statute applies what it may find to be the general commercial law in this country, irrespective of the decisions of the state court. Nor does the fact that the state decisions are based on what they deem to be the public policy or fixed public usage of the state change the situation. * * *

"Although the New York rule is not binding on this court, it would nevertheless be followed if there were any real conflict in the federal decisions, because, as happily phrased by Mr. Justice Cardoza in Mutual Life Ins. Co. v. Johnson, 293 U. S. 335, 55 S. Ct. 154, 156, 79 L. Ed. 398 (1934), 'the *summum jus* of power whatever it may be, will be subordinated at times to a benign and prudent comity. * * *' On the question here to be decided, however, the courts of the nation have spoken in no uncertain terms; the issue, far from being 'balanced with doubt,' has been resolved, with but a single exception, in a manner contrary to the New York decisions."

The foregoing quotation from Judge Mack's opinion discloses beyond question that he construed and understood the New York decisions as holding that such contracts as the one under consideration, to pay simple interest on interest coupons after their maturity, were against the public policy of that state and void. It is equally clear that the only reason he did not follow those decisions was because at that time, under the authority of *Swift* v. *Tyson*, 16 Pet. 1, 10 L. Ed. 865, he

could not do so in view of controlling contrary decisions on the subject by the Supreme Court of the United States.

On the strength of Judge Mack's opinion the trustee paid interest on the past due coupons until after the decision in *Erie Railroad Co.* v. *Tompkins, supra,* on April 25, 1938. Following that decision the trustee petitioned the court, District Judge Patterson presiding, for instructions in respect of future payments of interest on past due coupons, and it was in this situation that Judge Patterson wrote his opinion in 26 F. Supp. 954, so greatly relied upon by petitioners and the Commission.

Judge Patterson held that the decisions of the New York courts were to the effect that an agreement to pay compound interest on overdue installments of interest on an indebtedness created contemporaneously with the contracting of the indebtedness is void as against the public policy of that state, but that the courts of that state had never held that a contract made at the time of the creation of the indebtedness for the payment of simple interest on the overdue installments of interest was void as against public policy. In this connection, he stated:

> "While general statements may be found in New York cases to the effect that an agreement to pay 'interest on interest' is invalid, the fact is that the agreements under discussion were agreements to pay compound interest. In my opinion the cases dealing with agreements for compound interest do not touch the present case."

He further found the New York cases inapplicable because they were not dealing with cases in which there was a promise, made at the time of the loan, to pay simple interest on overdue interest installments or coupons. In this connection he said:

> "It thus appears that the New York courts have not rendered a decision on the validity of a covenant by a borrowing corporation to pay simple interest on overdue coupons. The argument for invalidity rests on the cases dealing with agreements for compound interest. But the reasons that led the New York courts long ago to condemn agreements for compound interest have only a remote bearing on agreements for simple interest on overdue coupons. On the other hand, there are strong reasons for concluding that a covenant to pay simple interest on overdue coupons is valid in New York. If there were a public policy against the allowance of such interest, the court in the Williamsburg case would hardly have sanctioned recovery of interest on a coupon held by one who did not hold the bond, where there was not even a covenant to pay such interest."

The New York cases do not sustain the analysis, nor justify the differentiation, undertaken to be made by Judge Patterson in his opinion.

From the very beginning of statehood the New York courts have taken the position that a covenant made in advance of the accrual of interest, to pay interest thereon from the date of accrual, is against public policy and void, and the opinions of the New York courts unmistakably disclose that no distinction was

made or intended to be made between true compound interest and simple interest on interest. The New York courts have used the terms interchangeably. The vice condemned was not the compounding of interest in the technical sense, but the collection of interest on interest which, in a measure, is compounding interest. The difference is one of degree and not of kind. At the time the New York courts adopted the rule, the same rule prevailed in England; and as shown by the opinions of the New York courts, the English opinions undoubtedly had their effect in shaping the policy of New York. The New York courts have been careful to point out that their decisions are not based upon the theory that interest upon interest is usury, but solely on the ground that such contracts are oppressive and therefore against the public policy of that state.

One of the first reported cases on the subject is that of *State of Connecticut* v. *Jackson*, 1 Johns. Ch. 13, decided in 1814. In this case there was involved a bond for $25,000.00 due in a stipulated number of years after date with interest from date until paid. Payments had been made on the obligation from time to time, and the matter was referred to a master to state the account and ascertain the amount due. In most, if not all, instances the payment made was less than the interest on the principal which had accrued to the date of payment. The master, in stating the account, computed the interest to the date of payment, added same to the principal, and then deducted therefrom the amount of the payment, and on the remainder (which, of course, included some interest) he com-

puted interest to the date of the next payment, and so on, to the date of the last payment.

The court held that the method followed by the master was incorrect; that the correct rule in such situations is that if the payment exceeds the interest on the principal to the date of payment, the payment must first be applied to the discharge of the interest then due and the surplus used to reduce the amount of the principal, and that subsequent interest is to be computed only on the balance of the principal then remaining unpaid; that if a payment is less than the interest, then the interest continues on the former principal until the payments in the aggregate equal or exceed the interest so computed, at which time the aggregate of the payments is applied to the payment of the interest then due, and any surplus remaining, to the reduction of principal, on which subsequent interest is calculated.

While the method used by the master in that case resulted in compound interest, and while that was the specific question under consideration by the court, the public policy announced by the court was not confined to a condemnation of compound interest in its technical sense. The court said:

> "This allowance of compound interest is not admissible, and the report must be sent back to the master for correction. There are cases in which interest is considered as changed into principal, and permitted to carry interest; as where a settlement of accounts takes place after interest has become due, or an agreement is then made that the interest due shall carry interest, or the

principal and interest are computed in a master's report and the same is confirmed. But, except in some special cases, *interest upon interest is not allowed, and the uniform course of the decisions is against it as being a hard and oppressive exaction, and tending to usury.*" (Emphasis ours.)

The emphasized language would seem to make it abundantly clear that the court was not thinking of compound interest in its technical sense, but as interest upon interest; but if it be thought that the use of that language was not necessary to a decision of that particular case, nevertheless, the language is important when we are trying to determine the attitude of the courts of New York on the question of the collection of interest upon interest.

The next sentence in the opinion, while not necessary to a decision of that case, demonstrates that the New York courts, as early as 1814 (the opinion of Judge Patterson to the contrary), regarded contracts made in advance of the accrual of interest, to pay simple interest thereon from the date of accrual, as against public policy and unenforceable. The court said:

> "Even an original agreement, at the time of the loan or contract, that if interest be not paid at the end of the year it shall be deemed principal, and carry interest, will not be recognized as valid. Such a provision would not amount to usury, so as to render the contract connected with it illegal and void in law; but this Court certainly, and perhaps, a court of law, would not give effect to such a provision."

It may be argued that in using the above quoted language the court had in mind the adding of interest to the original principal and the collection of interest on the resulting amount, but such is not the necessary import of the language. It is just as reasonable to conclude that the court meant to say that parties could not contract, in advance of the accrual of interest, that upon such accrual the amount so accrued should be treated as a principal sum and carry interest thenceforth.

In 1822 the New York Chancery Court (Chancellor Kent) decided the case of *M. & J. Van Benschooten* v. *Lawson*, 6 Johns. Ch. 313. There was involved in that case an agreement made after the accrual of interest to pay interest thereon back to the date that interest installment became due. While the opinion of the court refers to the agreement as one to pay compound interest, the facts as disclosed by the opinion unmistakably show that it was dealing with an agreement for the payment of simple interest on interest. The agreement was thus described by the court:

> "It was agreed on the 27th day of May, 1817, to allow interest for the year preceding on the interest which was due the year preceding."

The statement of facts preceding the opinion was in the following language:

> "Bill to foreclose a mortgage given on the 12th day of May, 1819 to secure the payment of a bond conditioned to pay $9,026.87 on the 12th day of May, 1820, with interest.

"It appeared in proof that this bond and mortgage was given for the balance of two prior bonds, the one dated May 2, 1814, for $4,750.00, payable the first day of May, 1815, with interest, and the other dated 27th of May, 1817, for $737.00 given for the arrears of interest remaining unpaid on the prior bond; and that on giving this last bond for $737.00, interest on the previous interest remaining unpaid was calculated for the year it had remained due and unpaid and was included, which compound interest amounted to $29.42.

"It appeared also that a judgment bond was taken on the 24th day of April, 1821, for $966.65, being for arrears of interest on the bond and mortgage on which this Bill is founded and that $24.87 of unpaid interest on interest which had remained due and unpaid was also included in this judgment bond which had been assigned by the plaintiffs to a third party.

"The case was submitted upon the pleadings and proof, whether these charges of compound interest were admissible."

It is apparent from the foregoing statement that the two questioned items of $29.42 and $24.87 were not true compound interest but simple interest on unpaid installments of interest. Nevertheless, note this language of the court:

"Compound interest can only be admitted on the fact of a written agreement made *after* the interest upon which the agreement operates has fallen due; and to give such an agreement a retrospective effect leads to oppression. It is equally

objectionable, *after an agreement made at the time of the original contract or loan, that compound interest shall begin and run upon the lawful interest the moment it falls due, whether payable yearly, half yearly or quarterly; and such agreements are held to be oppressive* * * *. If the creditor was permitted to exact from the debtor a stipulation to pay interest on arrears of interest then due, it would lead to great and inevitable abuse. It would, perhaps, be less mischievous, because the parties would stand upon more equal terms, to allow of such a stipulation for compound interest, when the original contract is about to be made, the parties are then independent of each other; but in the other case the debtor is comparatively dependent, and probably distressed, and the creditor exacts the stipulation under the evident advantage of power and superiority. The agreement on the part of the defendant, to pay compound interest retrospectively, does not alter the case." (Emphasis ours.)

The court disallowed both of the items of interest on interest.

Mowry v. *Bishop*, 5 Paige's Ch. 98, was decided in 1835. The court in that case pointed out that while under the law of most of the states it is perfectly legal to make a contract at the time of the creation of a debt to pay interest on interest installments from their due date, such a contract is not valid in New York. The court said:

"In this state it appears to be settled that an agreement to pay interest on interest which may accrue after the making of such an agreement,

cannot be legally enforced, although it does not render the agreement usurious. This principle is merely adopted as a rule of public policy to prevent an accumulation of compound interest in favor of negligent creditors who do not call for the payment of their interest as it becomes due."

Toll v. *Hiller,* 11 Paige's Ch. 228, was decided in 1844. The question involved was the allowance of interest upon past due installments of interest. The chancellor held that while he could see no equitable reason why unpaid annual installments of interest on a debt which was to run several years should not bear interest from maturity, nevertheless, under the law of New York, this was not allowed. He said:

"It may be proper to say, however, that as the interest was, by the condition of the bond and mortgage, to be paid annually, it would be perfectly equitable to receive interest on such interest from the time it was payable; although for special reasons of policy, courts will not allow interest upon interest unless there is a special agreement to pay interest thereon after the original interest has become due and payable."

Forman v. *Forman,* 17 Howard's Practice Rep. 255 (New York Supreme Court), was decided in 1859. The opinion in part reads as follows:

"I know of no principle or adjudged case that authorizes the recovery of compound interest in an action at law unless there has been a promise in writing to pay interest after it could be said to be morally due, or without proof of some peculiar facts not established in this case."

Stewart v. *Petrie,* 55 N. Y. 621, was decided in 1874. In this case a mortgage by its terms was to run for several years with interest payable annually. The mortgage, as well as the interest, was past due. Upon the institution of foreclosure proceedings an agreement was entered into to extend the time of the payment of the mortgage provided the mortgagor would pay interest on the arrears of interest. This agreement was attacked solely on the ground that it violated the New York usury statute, and while that was the only question necessary to be decided, the case is of vital importance because it contains an expression of opinion by the court of last resort of New York as to the validity of agreements, made at the time a debt is created, to pay interest on defaulted installments of interest. The court said:

> "The only defense interposed was usury upon the ground that the note was given for interest upon arrears of interest, or compound interest on a mortgage long past due, held by the payee of the note, the payment of which was further extended upon receipt of the note. There was no conflict in the evidence of any disputed fact; and there was no request by the defendant to go to the jury on the question of intent, or whether the transaction was colorable and intended as an evasion of the law prohibiting the taking of usury. The receiving of interest upon interest is not a violation of the statute of usury, as no more than seven per cent is in such cases taken or received. *It is true that an agreement in advance for the payment of interest upon interest after the same shall accrue can not be enforced, not because it is*

usurious but for the reason that such an agreement is regarded in this state as against public policy—as one that may be made oppressive to the debtor; but a prospective agreement, after the interest has accrued, to pay interest thereon is valid and money paid for compound interest can not be recovered back." (Emphasis ours.)

From the emphasized language quoted above, it will be observed that the New York court again failed to make any distinction between true compound interest and interest upon interest.

Young v. *Hill*, 67 N. Y. 162, was decided in 1876. That case involved the right to charge true compound interest retrospectively under an alleged agreement made after default in the payment of simple interest on the obligation. The court held that such an agreement would not be enforced. Judge Patterson, in his opinion in the *American Brake Shoe & Foundry Company* case, *supra*, rather tentatively suggested that this case supports his view that the New York cases have not condemned contracts to pay simple interest on past due installments of interest, and cites the following language of the opinion in support thereof:

> "An agreement to pay simple interest upon the several installments of interest as they become due, and a computation based upon such agreement applying the payments as made first to the payment of interest until all was paid, might not be unreasonable or inequitable."

That language falls far short, however, of holding that such contracts would be enforceable in New York.

When we consider the prior decisions of the New York courts hereinbefore referred to, and many of which are cited and relied upon in the case of *Young* v. *Hill*, as well as language of the opinion which preceded the language quoted by Judge Patterson, we submit that there is no basis whatever for believing that that case was intended to announce any rule different from that theretofore consistently followed by the New York courts. We call attention to the following language of the opinion preceding the language quoted by Judge Patterson:

> "When, by the terms of an obligation, interest is payable at stated periods, interest upon interest from the time it becomes due, only gives the creditor the usual and legal equivalent for the non-payment of money payable at a day certain, and in some States recovery may be had of interest upon interest under such circumstances without a special contract to that effect. With us it is not allowed. Two propositions are definitely settled by adjudication: first, that an *agreement to pay interest upon interest must, in order to its validity, be made after the interest which is to bear interest has become due*, and, second, that it must be supported by a sufficient consideration." (Emphasis ours.)

Thus we again find the New York Court declaring that not only agreements to pay compound interest on past due installments of interest are against the public policy of New York, but that an agreement to pay interest upon interest made at the time the debt is created is against the public policy of that state.

Chronologically the next case which should be considered in determining the law of New York applicable to the issue here involved is that of *Bailey* v. *Buchanan County*, 115 N. Y. 297, 22 N. E. 155 (decided in 1889). That case is the foundation for the rule in New York that interest coupons attached to bonds, until detached *and separately negotiated* constitute a part of the bond, and that they give the owner of the bond no greater right than the stipulation in the bond itself to pay interest. In that case the holder of certain coupon bonds was contending that he could not be required to surrender his bonds and all of its coupons for redemption upon the payment of the redemption price together with interest on the face of the bonds to the date of redemption, notwithstanding the interest paid at redemption included that represented by past due coupons. His contention was that the coupons were in the nature of independent negotiable instruments and upon failure to pay them when due, he was entitled to interest on those coupons. The lower court sustained the contention of the bondholder, but on appeal the Court of Appeals of New York reversed. The Appellate Court said:

> "It was held at the general term that the coupons past due and detached from the bonds at the time of the tender were independent negotiable instruments, and that the defendant therefore had no right to demand their surrender for payment as a condition of the payment of the bonds, and that the tender was not good, because it was not an unqualified offer to pay the bonds and the interest thereon for the month of July. We are of

opinion that the learned general term fell into error. It is true that past-due coupons payable to bearer, when detached from the bonds, are for many purposes independent, separate instruments. They may be negotiated, and may be sued upon by the holder without the production of the bonds. Murray v. Lardner, 2 Wall. 110; City v. Lamson, 9 Wall. 477; City of Lexington v. Butler, 14 Wall. 289; Clark v. Iowa City, 20 Wall. 583; Amy v. Dubuque, 98 U. S. 470; Evertson v. Bank, 66 N. Y. 14; McClelland v. Railroad Co., 110 N. Y. 469, 18 N. E. Rep. 237. But the coupons, nevertheless, always have some relation to the bonds. Their force and effect and character may be determined by reference to the bonds. They are secured by the same mortgage, and, although unsealed, are specialties like the bonds, and are governed by the same statute of limitations which is applicable to the bonds. Until negotiated, or used in some way, they serve no independent purpose; and while they are in the hands of the holder they remain mere incidents of the bonds, and have no greater or other force or effect than the stipulation for the payment of interest contained in the bonds; and while they remain in the ownership and possession of the owner and holder of the bonds it can make no difference whether they are attached to or detached from the bonds, as they are then mere evidence of the indebtedness for the interest stipulated in the bonds."

In 1893 the Court of Appeals of New York decided the case of *Williamsburgh Savings Bank* v. *Town of Solon*, 136 N. Y. 465, 32 N. E. 1058. There was involved in that case the right to collect interest on past

due interest coupons in the hands of the holder of the bonds to which they were attached. There was no covenant in the deed of trust securing the bonds, nor in the bonds or coupons themselves, that interest would be paid on past due coupons. The lower court allowed interest on the past due coupons, but the Court of Appeals of New York reversed the lower court on this point, using the following language:

> "But there is a remaining question open for consideration, and that is the allowance of interest upon the coupons from their date. It results in an award of compound interest, which we have held not to be recoverable, except upon some new and independent agreement, made upon sufficient consideration. Young v. Hill, 67 N. Y. 162. The inquiry here is, of course, whether the coupons sued come within that exception, and the solution of the problem depends upon their nature. We have already, in this court, determined what they are, and described their character and quality. In Bailey v. County of Buchanan, 115 N. Y. 297, 22 N. E. Rep. 155, Earl, J., said that while it was true that past-due coupons, payable to bearer, when detached from the bonds, are for many purposes separate and independent instruments, which may be negotiated and sued upon without the production of the bonds, yet such coupons always have some relation to the bonds; that, until negotiated or used in some way, they serve no independent purpose; that, while they are in the hands of the holder, they remain mere incidents of the bonds, and have no greater force or effect than the stipulation for the payment of interest contained in the bonds; and that, while they continue in such own-

ership and possession, it can make no difference whether they are attached or detached, as they are then mere evidences of the indebtedness for the interest stipulated in the bonds. I think that adjudication concludes us, and a re-examination of the question in the light of the very full and able discussion in the present case only strengthens the conclusion then reached, in which we all concurred. Interest, as a rule, follows the principal, without becoming principal, and cannot be compounded by force, merely, of the contract; but that general rule has been modified somewhat by an exception growing out of the character and purpose of interest coupons. They may become separate and independent instruments. When they do, the exception is for the first time needed, and for the first time applies. Until they do, the promise is merely to pay interest, and is governed by the usual rule. They do not become separate and independent instruments until they are utilized as such. Before that occurs, and while they remain in the hands of the holder of the bonds, the occasion for the exception has not arisen, and the exception does not apply. That is plaintiff's situation. It is true it was prevented from suing by an injunction, but the damages occasioned by it are awarded on its dissolution, and theoretically at least, cover all losses thereby sustained. It follows, therefore, that the judgment for the plaintiff was erroneous to the extent of its award of interest upon the coupons, and should be modified by deducting therefrom the sum of $4,244.52, and, as modified, be affirmed, without costs to either party in this court."

Notwithstanding the statement of Judge Patterson in the *American Brake Shoe & Foundry Company* case, *supra*, that none of the New York cases involved simple interest on interest, we submit that the quoted language shows that that is all that was involved in the *Williamsburgh Savings Bank* case; yet the New York court again refers to the interest on coupons as compound interest. This case reaffirms the doctrine laid down in the case of *Bailey* v. *Buchanan County*, 115 N. Y. 297, 22 N. E. 155, that interest coupons can not be regarded as independent negotiable instruments entitled to draw interest from maturity, unless they have been detached from the bond and negotiated; and that unless they have been so detached and separately negotiated they are in exactly the same class as any other ordinary unpaid interest installment. Judge Patterson in his opinion calls attention to the fact that the deed of trust in the *Williamsburgh Savings Bank* case contained no provision for the payment of interest on past due interest coupons, and intimates that had such a provision been incorporated in the deed of trust the result in that case would have been different. A moment's reflection will demonstrate the fallacy of the suggestion. Not only that case held, but every New York case on the subject preceding it had held, that it is against the public policy of New York to permit the collection of interest on interest. Can it be imagined that the parties by contract could defeat such public policy? The question answers itself.

The fact that the New York courts are firmly committed to the doctrine that past due interest coupons

occupy no higher position, under New York law, than any other past due interest installment, unless detached and separately negotiated, is further evidenced by *Continental Securities Co.* v. *New York Central & H. Railroad Co.*, 217 N. Y. 119, 111 N. E. 484, 486. Judge Cardoza, writing for the court, said:

> "It makes no difference that the promise to pay interest is represented by coupons. Until detached and separately negotiated, a coupon is merely an incident of the bond without greater force than any other promise for the payment of interest. Williamsburgh Savings Bank v. Town of Solon, 136 N. Y. 465, 481, 32 N. E. 1058."

In *Newburger-Morris Co.* v. *Talcott*, 219 N. Y. 505, 114 N. E. 846 (decided in 1916), there was involved a contract between a principal and its factor under the terms of which the principal was to consign to the factor goods which it then owned or thereafter acquired, and the factor was to sell them and collect the purchase price and to settle with his principal at stated intervals. Pending such settlements he agreed to make advances to the principal based upon the net cost of the merchandise and upon the outstanding accounts for merchandise sold. He was to receive a certain commission on merchandise sold and interest on the advances made by him. In his statements to his principal he had compounded the interest on his advances. Judge Cardoza wrote the opinion of the court, and while the right to so compound interest was the question in the case, the opinion shows what that eminent New York lawyer understood to be the law of that state in respect of con-

tracts for the payment of interest on past due installments of interest. He said:

> "The charge of compound interest was correctly disallowed. The rule is settled that a promise to pay interest upon interest is void if made at a time before simple interest has accrued. Young v. Hill, 67 N. Y. 162, 23 Am. Rep. 99. The provision in the contract that interest shall be 'charged on the account current * * * at the rate of six per cent per annum' must therefore mean simple interest. Any other promise, made at the outset of the dealings, would be invalid."

In *Chase National Bank* v. *Clark Henry Corp.*, 156 Misc. 767, decided by the New York Supreme Court, there was involved the validity of an agreement, contained in a trust indenture executed to secure an issue of bonds, to pay interest on overdue principal and overdue installments of interest, almost identical in language with the provision under consideration in the case at bar. The referee, to whom the case had been referred, in a written opinion rejected the claim for interest on past due installments of interest on the ground that it was against the public policy of New York, and he cited in support thereof a great many of the New York cases which we have analyzed in this brief, and the Supreme Court ratified his opinion and entered a judgment denying interest on past due interest coupons.

In view of the unbroken line of New York cases from 1814 down to the present time, it is difficult to understand how Judge Patterson reached the conclu-

sion he did in the *American Brake Shoe & Foundry Company* case, *supra,* unless he was unconsciously swayed by his conviction of what the law on the subject ought to be. The diligence of counsel has not resulted in the petitioners and the Commission finding any reported cases, state or Federal, agreeing with Judge Patterson's analysis of the purport of the New York decisions, except the single case of *In re Realty Associates Securities Corporation,* 66 F. Supp. 416 (District Court, Eastern District of New York). In that case, District Judge Moscowitz did agree with Judge Patterson in his analysis of the New York cases, but his discussion of the matter covered less than one printed page and upon reading same, it is perfectly apparent he decided the question as he did largely in reliance upon Judge Patterson's opinion.

As we have heretofore shown, Judge Julian W. Mack wholly disagreed with Judge Patterson on the meaning and effect of the New York decisions. The question of what the law of New York is on the subject was also before the Circuit Court of Appeals for the 6th Circuit in *In re Columbus S. H. & H. R. Co.,* 109 Fed. 177; the Southern District of New York (District Judge Clancy), in *Transbel Inv. Co.* v. *Roth,* 36 F. Supp. 396, decided in 1940; and the District Court of Minnesota in *In re Wisconsin Cent. Ry. Co.,* 63 F. Supp. 151, decided in 1945; and after a thorough consideration and analysis of substantially the same cases considered and analyzed in this brief and in Judge Patterson's opinion, each of those courts reached the conclusion that under those decisions a contract made

at the time a debt is contracted to pay interest on an interest installment after its maturity is against the public policy of New York and void. We especially commend to the careful consideration of the Court the painstaking analysis of the New York decisions contained in the opinion of Judge Nordbye in *In re Wisconsin Cent. Ry. Co., supra.*

At page 25 of the brief of the Vanston Committee and at page 3 of the Van Horn Committee's brief, it is argued that the defense of illegality of the contract here involved is not available for the reason that under Section 374 of the General Business Law of the State of New York, a corporation may not interpose the defense of usury in any action. Of course, there is no merit whatever in this contention. We do not contend that the contract here involved is void on the ground that it violates the usury laws of New York. Usury consists of charging or collecting a greater rate of interest than is permitted by law. The objection to the contract here is that it provides for the payment of *any* interest on interest. Three of the New York decisions analyzed by us in this brief make it clear that such contracts are not condemned because they are usurious, but because they are against the general public policy of the state.

For the convenience of the Court, we repeat earlier quotations in this brief from those three cases on that subject:

> "In this state it appears to be settled that an agreement to pay interest on interest which may accrue after the making of such an agreement,

can not be legally enforced, *although it does not render the agreement usurious.*" (Emphasis ours.)

Mowry v. *Bishop,* 5 Paige's Ch. 98, *supra.*

"It is true that an agreement in advance for the payment of interest upon interest after the same shall accrue cannot be enforced, *not because it is usurious* but for the reason that such an agreement is regarded in this state as against public policy—as one that may be made oppressive to the debtor * * *." (Emphasis ours.)

Stewart v. *Petrie,* 55 N. Y. 621, *supra.*

"Even an original agreement, at the time of the loan or contract, that if interest be not paid at the end of the year it shall be deemed principal, and carry interest, will not be recognized as valid. Such a provision would not amount to usury, so as to render the contract connected with it illegal and void in law; but this Court certainly, and perhaps, a court of law, would not give effect to such a provision."

State of Connecticut v. *Jackson,* 1 Johns. Ch. 13, *supra.*

In conclusion, we wish to suggest that the equities of this case are with the second-mortgage holders. We fully recognize that if the first-mortgage bondholders, as a matter of law, are clearly entitled to receive interest on the past due coupons, they cannot be deprived of that right because of the hardship its enforcement will visit upon the holders of the second-mortgage securities. On the other hand, if there is any substantial doubt as to their legal right to receive such interest, it

should be resolved against them. The record shows, as will doubtless be admitted, that the first-mortgage bondholders are certain of receiving the face amount of all their bonds, the face amount of all their coupons, and interest on the face amount of their bonds at the stipulated rate until they are paid. If, in addition, they receive interest on their coupons, there will be nothing left for the holders of the second-mortgage securities. In this situation, the first-mortgage bondholders should not be permitted to pick the carcass clean, unless the applicable law unmistakably commands such a result.

Respectfully submitted,

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